STATE OF CALIFORNIA

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March 8, 1990

Dear Mr.

This is in response to your letter of January 16, 1990 to in which you request our opinion with respect to the following contemplated transactions described in your letter.

> Your office represents two closely held California limited partnerships, identically owned brother-sister partnerships. One partnership, which we will refer to as the "Property Partnership," holds substantial real property. The other partnership, which we will refer to as the "Operating Partnership" conducts an active trade or business, renting on an oral month-to-month tenancy three separate parcels from the Property Partnership from which it conducts its business. The Property Partnership also owns substantial real property which it leases to third parties.
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> It is the desire of the managing general partner of both partnerships that the Operating Partnership protect its interest in the three parcels which it rents from the Property Partnership by obtaining from the Property Partnership long term leases, including option periods, totalling 99 years. By this means the Operating Partnership will protect its right to control and possession of three key locations from which the Operating Partnership does business. Several of the partners are elderly and there is a concern that in the future the partnerships may cease to be identically owned brother-sister partnerships and control of the partnerships may fall into different hands.
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> It is further contemplated that after the leases between the Property Partnership and the Operating

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Partnership are executed that the Property Partnership will distribute to one of its limited partners, holding an approximately 23% interest in the partnership, one of the three parcels of real property leased by the Property Partnership to the Operating Partnership subject to the 99 year lease, and that the limited partner receiving the parcel will withdraw from the Property Partnership.

The question presented by the foregoing proposed transactions is whether Revenue and Taxation Code* section 62(a)(2) is applicable to exclude the proposed lease transactions from change in ownership.

LAW AND ANALYSIS

Change in ownership is defined by section 60 to mean "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."

Section 61 provides in relevant part that "[e]xcept as otherwise provided in Section 62, change in ownership, as defined in Section 60, includes, but is not limited to: * * * (c)(1) [t]he creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options) * * * .

Section 62 provides in relevant part that "[c]hange in ownership shall not include: (a) * * * (2)[a]ny transfer between * * * legal entities * * * which results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer. The provisions of this paragraph shall not apply to transfers also excluded from change in ownership under the provisions of subdivision (b) of Section 64." (See also Cal. Code Regs., tit. 18 § 462(j)(2)(B) and 462(m)(5)).

Here, the creation of leasehold interests in three parcels of real property for 99 years including renewal options in favor of Operating Partnership is clearly a change in ownership under section 61(c) unless section 62(a)(2) is applicable.

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*All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

Although section 62(a)(2) by its express terms contemplates a change in the method of holding title to real property (and it would clearly apply if the three parcels were transferred in fee to Operating Partnership), we have taken the position that its provisions can apply where there has been no change in the method of holding title as long as the proportionality requirement is satisfied. For example, we have taken the position that transfers of ownership interests in legal entities, (e.g., stock or partnership interests), which otherwise would be changes in ownership under section 64(c) or 64(d) are excluded from change in ownership under section 62(a)(2) where proportionality is maintained despite the fact that there has been no change in the method of holding title to real property. The rationale for this position is that although section 62(a)(2) by its terms applies to transfers of real property which otherwise would be changes in ownership it is proper to apply it to changes in ownership under sections 64(c) or 64(d) because a change in ownership under either of those sections is in legal effect a transfer of the real property of the legal entity. Similarly, we believe the same rationale should apply to the creation of a leasehold interest in taxable real property for a term of 35 years or more because, under section 61(c), that is in legal effect a transfer of real property. Accordingly, we are of the opinion that section 62(a)(2) can apply with respect to the creation of a leasehold interest in real property for a term of 35 years or more, despite the fact there has been no change in the method of holding title provided that section 62(a)(2) is otherwise satisfied.

If the transactions which are contemplated here can properly be characterized as two separate and unrelated transactions, they would not result in a change in ownership. The first transaction, i.e., the creation of the leasehold interest for a term of 99 years while normally a change in ownership under section 61(c) would be excluded from change in ownership under section 62(a)(2) as indicated above. The second transaction, i.e., the transfer of Property Partnership's lessor's interest in one of the parcels of real property subject to a lease with a remaining term in excess of 35 years to the withdrawing limited partner would be excluded from change in ownership under section 62(g). (Since we have insufficient facts, we express no opinion concerning the change in ownership implications with respect to other real property of Property Partnership as a result of the withdrawal of a limited partner.)

The courts have held, however, that where a taxpayer has embarked on a series of transactions that are in substance a single, unitary or indivisible transaction, the intermediary steps will be disregarded and credence given only to the

completed transaction. Redwing Carrier, Inc. v. Tomlinson (1968) 399 F.2d 652, 654.

Accordingly, if the transactions can properly be characterized not as two transactions but one integrated transaction, then section 62(a)(2) would not apply in our view and there would be a change in ownership of all the parcels. The reason for this conclusion is that although the distribution of one of the parcels from Property Partnership to the withdrawing limited partner would be excluded from change in ownership under section 62(g), the proportional ownership interests in each of the three parcels as represented by partnership interests would not remain the same after the transfer. Before the lease, the withdrawing partner's interest in each property was 23 percent. Afterwards, his interest in the leasehold would remain the same through his partnership interest in Operating Partnership but his interest in the reversion would change as to each of the three parcels, i.e., 100 percent for the distributed parcel and zero percent for the other two.

Whether a series of transfers constitute for tax purposes one or several transactions is a question of fact. United States v. Cumberland Pub. Serv. Co. (1950) 338 U.S. 451; Commissioner v. Court Holding Co. (1945) 324 U.S. 331.

In making this determination, the courts have applied three alternative tests; the "binding commitment" test, the "interdependence test" and the "end result" test. Under the "binding commitment" test, a series of transactions will be collapsed if, at the time the first step is entered into, there was a binding commitment to take the later step. Penrod v. Comm (1987) 88 TC 1415, 1429.

Under the "interdependence test," the inquiry is "'whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'" King Enterprises, Inc. v. United States (1969) 418 F.2d. 511, 516.

Under the "end result" test, a series of formally separate steps are treated as a single transaction if it appears that they are really prearranged parts of a single transaction intended from the outset to reach the ultimate result. Penrod, supra, King Enterprises, supra.

Since you have advised us that both steps are contemplated from the outset in this case, it appears that the transactions may be integrated rather than separate. That factual determination, however, would be made by the assessor and not us after the transactions are completed.

As I mentioned in our telephone discussion, section 62(a)(2) would be applicable even if the transactions were treated as integrated if the second step of the transaction provided for a distribution to the withdrawing limited partner of an undivided interest in each of the three parcels equal to his partnership interest in Property Partnership. If the transactions are carried out as contemplated, however, there is a possibility that the assessor will treat them as one integrated transaction and reappraise all three parcels as indicated above.

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county. You may wish to consult the appropriate assessor in order to confirm that the described property will be assessed in a manner consistent with the conclusion stated above.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

Tax Counsel

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cc: Mr.
Mr.